No. 12908

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

J. J. McDONELL,

Appellant,

vs.

PAUL W. SAMPSELL, Trustee of the Estate of Hacker-Byrnes Corporation, bankrupt,

Appellee.

APPELLANT'S OPENING BRIEF.

BENJAMIN & KRONICK,
756 South Broadway,
Los Angeles 14, California,
Attorneys for Appellant.

Parker & Company, Law Printers, Los Angeles. Phone MA. 6-9171.

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Appellee.

APPELLANT'S OPENING BRIEF.

I.

JURISDICTIONAL STATEMENT.

A. The District Court Had Jurisdiction of This Cause.

As a court of bankruptcy, the District Court of the Jnited States had jurisdiction in this cause, pursuant to he Act of July 1, 1898, Chapter 541, Sections 1 and 2; 30 Stat. 544, 545, as amended; 11 U. S. C. A. (Supp.), Sections 1 and 2 (1950). The involuntary bankruptcy petition was filed on April 27, 1949 [Tr. pp. 3-8]. After .n order of general reference, the court adjudicated Hack-r-Byrnes Corporation bankrupt on May 12, 1949 [Tr. pp. 8-10]. Thereafter appellant filed two claims, one laiming priority for wages in the sum of $600.00 and a

general claim for balance of wages, in the sum of $16,-064.00 [Tr. pp. 15-18]. Subsequently, on December 14, 1949, the Trustee in Bankruptcy filed objections to the aforesaid claims and a Notice of Hearing on said objections. After hearing on said objections, the Referee, on April 26, 1950, made an order denying the priority of the $600.00 claim, but allowing same as a general claim and allowing the $16,064.00 claim as a general claim, with the further order that both of said claims should be subordinated in payment to the claims of all other general creditors of said bankrupt (Act of July 1, 1898, Chap. 541, Sec. 39(a); 30 Stat. 555, as amended; 11 U. S. C. A., Sec. 67(a) (1950) [Tr. pp. 21-34]. Within ten days after the entry of said Referee's Order, appellant filed his Petition for Review by the District Court Judge (Act of July 1, 1898, Chap. 541, Sec. 39(a); 30 Stat. 559, as amended; 11 U. S. C. A., Sec. 67(a) (1950) [Tr. pp. 35-39]; thereafter the Judge wrote an opinion affirming the Order of the Referee dated April 26, 1950, and the Judge's order affirming Referee was entered on February 21, 1951 [Tr. pp. 40-41].

B. The Circuit Court of Appeals Has Jurisdiction of This Appeal.

The jurisdiction of the Circuit Court of Appeals of the United States is invoked pursuant to Sections 24 and 25 of the Bankruptcy Act (Act of July 1, 1898, Chap. 541, Secs. 24, 25; 30 Stat. 553, as amended; 11 U. S. C. A. (Supp.), Secs. 47, 48 (1950)). Appellate jurisdiction over this proceeding in bankruptcy vested in the Circuit Court of Appeals upon the filing on March 21, 1951, of the notice to appeal, the amount involved being in excess of $500.00 [Tr. p. 42].

II.

STATEMENT OF THE CASE.

This appeal is from the District Court's "Order Confirming Referee's Order on Objections to Claim of J. J. McDonell, *et al.,*" dated and entered on February 21, 1951 [Tr. pp. 40-41].

The appellant's claims having been allowed as general claims by the Referee, the Petition for Review by the District Court Judge was directed only to that portion of the Referee's Order relating to the subordination of said claims and, therefore, the only question to be argued on this appeal is whether or not said order of subordination should have been affirmed. Appellant contends that the Court and the Referee were in error in ordering subordination.

The facts in the case at bar, are briefly as follows:

Claimant, J. J. McDonell entered the employ of the bankrupt corporation in the first week of September, 1947 [Tr. p. 52]. That prior to said date, he had been employed by Walton N. Moore Dry Goods Co., for the period of approximately 11 years; at said time he had had 25 years experience in the carpet and floor covering business [Tr. p. 54]. He left his employment with said firm at the request of Mr. Raymond Hacker, president of the bankrupt corporation, who employed him as the manager of the carpet department at a salary of $15,000.00 per year, plus 50% of the net profits of the carpet department [Tr. pp. 53-54; 64-65]. That for the first 6½ months of 1947 he earned $7652.00 plus his automobile expenses which would make his annual earnings at that time approximately $15,000.00 [Tr. pp. 54-55].

On or about December 1, 1947, Raymond Hacker, who at that time owned one-half of the outstanding stock of the Hacker-Byrnes Corporation, purchased the other one-half of the outstanding stock from J. J. Byrnes [Tr. pp. 105]. At the time of the sale, Byrnes resigned as an officer and director and Hacker made the claimant a director and officer of the Hacker-Byrnes Corporation [Tr. pp. 75, 106] and appointed him General Manager of the corporation at a guaranteed salary of $20,000.00 per year, plus a percentage of the profits [Tr. pp. 58-59]. Claimant at no time owned any stock in the bankrupt corporation nor did he ever have any financial interest therein [Tr. p. 75].

About the middle of the year 1948, some new parties became interested in the corporation, whose names are Maury Sommers, Mark Boyar and Dave Kaplan and claimant was then asked to resign as an officer and director, which he did [Tr. p. 75]. However, he remained as the General Manager of the company. In September, 1948, he attempted to resign as General Manager because he had received an offer of another position, but was requested to stay on by the new parties who told him that they were going to put $100,000.00 cash into the business [Tr. p. 71]. On February 18, 1949 [Tr. p. 60] he finally resigned and the claims herein, aggregating $16,-646.00, represent the difference between the guaranteed salary agreed to be paid to him and his drawings against the same, from September, 1947, to February 18, 1949. In view of the fact that it has been held that these claims are valid and enforceable obligations, appellant will not burden the Court with the circumstances relating to the

manner and method of paying claimant's salary. The bankrupt corporation, up to the time that the new interests came in, was a one-man corporation, dominated and solely controlled by Raymond Hacker, who up to that time owned all of the stock of said corporation [Tr. p. 105]. Since the bankruptcy, the Trustee has filed suits against the new interests to recover moneys and property, alleged to have been fraudulently withdrawn by them from the corporation prior to its bankruptcy.

The following questions are presented by this appeal:

(1) In view of the fact that it has been held that the claims are valid and enforceable obligations and no fraud or unfairness has been proven in connection therewith, should not the appellant be entitled to receive his pro-rata dividends out of the estate on a parity with other general creditors and not have his claims subordinated to those of other general creditors, which for practical purposes amounts to a complete denial and rejection of his claim, because the assets of the bankrupt corporation are insufficient to pay all other general creditors in full?

(2) As the claimant had not been an officer or director of the bankrupt corporation for about eight months prior to the adjudication in bankruptcy and at no time had any control of the policies of the corporation and as said bankruptcy could not be attributed to any act or conduct of his and as the salary the corporation had agreed to pay him was fair and in keeping with amounts he had earned in previous employment, then should he not be entitled to share pro-rata with other general creditors of the bankrupt estate?

III.

SPECIFICATIONS OF ERROR.

Appellant relies upon the following specifications of error:

1. The District Court erred in assuming that the contract of employment between appellant and bankrupt was not entered into in good faith and that there was fraud or unfairness connected therewith [Tr. pp. 170-172, points 1, 4].

2. That the District Court erred in assuming that appellant was an officer and director of the bankrupt corporation until its insolvency in 1949 and that there were acts, conduct or breaches of duty on his part which contributed to the insolvency, which is contrary to the facts and evidence [Tr. pp. 170-172, points 3, 6, 9, 13].

3. The District Court erred in disregarding the appellant's experience and the amount of salary he received prior to his employment with the bankrupt corporation, as well as the extent and magnitude of the business transacted by the corporation during appellant's employment therewith, in affirming a finding that the amount of salary was inequitable or unjust insofar as other creditors were concerned [Tr. pp. 171, 172, points 5, 8, 11, 12].

4. That the District Court erred in ordering subordination of appellant's claim after same had been allowed as a general claim, in contravention of Section 65a of the Bankruptcy Act [Tr. pp. 170, 172, points 2, 10].

5. That the District Court erred in affirming a finding of the referee that appellant's employment with the bankrupt corporation amounted to a joint venture, when in fact there is no evidence to substantiate said finding [Tr. p. 171, point 7].

IV.

SUMMARY OF THE ARGUMENT.

A. The contract of employment between appellant and bankrupt was entered into in good faith and was wholly free of fraud or unfairness.

B. The appellant was not an officer or director of the bankrupt corporation for some time prior to its adjudication and was not responsible for nor did he contribute to its bankruptcy.

C. The salary agreed to be paid to appellant was fair and reasonable and such agreement was not inequitable or unjust to other creditors.

D. The District Court's Order violates the equality of distribution of general assets guaranteed by the Bankruptcy Act.

E. Appellant's employment with the bankrupt corporation did not constitute a joint venture.

V.
ARGUMENT.

A. The Contract of Employment Between the Appellant and the Bankrupt Was Entered Into in Good Faith and Was Wholly Free of Fraud or Unfairness.

In support of this argument, we need only point out that the Referee found and the District Court affirmed the fact, that the contract of employment was a valid and enforceable one as set forth in Paragraphs I and II of the Conclusions of Law [Tr. pp. 29, 30] and the order of the Referee allowing appellant's claims under said contract as general claims [Tr. p. 33]. The Findings of Fact and Conclusions of Law, therefore, irrefutably support appellant's contention that the contracts of employment between the bankrupt corporation and appellant were free of any fraud or unfairness for the reason that had there been any fraud involved or connected therewith, the Referee would not have ordered the allowance of these claims as general claims and the District Court would not have affirmed such order. The facts involved also support this contention as it was shown, without contradiction, that prior to his employment with the bankrupt corporation as the manager of its carpet department, appellant had had 25 years experience in the carpet and floor covering business [Tr. p. 54]. That immediately prior to said employment he had been employed by the Walton N. Moore Dry Goods Co., for approximately 11 years and that his earnings at the time he came to the bankrupt corporation amounted to approximately $15,000.00 annually [Tr. pp. 54-55]. It, therefore, could not be asserted in any manner that the contract of employment was tainted with fraud or unfairness, he having

ecome employed by the bankrupt corporation at approxi-
nately the same salary that he had been earning prior
hereto; also, thereafter when he was given a higher
osition and more onerous duties by being elevated to the
eneral managership of the business, his guaranteed
alary was increased to $20,000.00 per annum and that
uch increase in salary was fair and commensurate with
he added duties and responsibility. There is no testi-
nony that at the time these contracts were entered into,
hat the bankrupt corporation was insolvent. As a matter
f fact, the only reference made thereto is in Paragraph
X of the Findings of Fact [Tr. p. 28] by the wording
'that throughout the year 1948 the bankrupt corporation
vas experiencing financial difficulties due to shortage of
iquid capital." The testimony also is that for the first
5 or 7 months that appellant was employed, the operation
f the bankrupt corporation was profitable and that the
lifficulties began happening in the latter part of 1948
Tr. p. 66]. It must be noted that at that time, appellant
vas no longer an officer and director as he had resigned
rior thereto.

A solvent corporation has the right to do with its money
s it sees fit and to enter into such obligations as it sees
it, as long as the dealings are honestly carried on with
eference to the creditors and stockholders.

In re American Range and Foundry, 22 F. 2d 558.

This case holds that the fact that a contract for services
vas entered into with a director who with his son was the
ole owner of all of the corporate stock thereof, does not
f itself give the court the right to disallow his claim for
ervices filed in bankruptcy or to subordinate it to other
reditors, where there is no fraud or unfairness shown.

The failure of the officers and directors in their attempt to make a corporation's business successful, is not a sufficient basis to justify penalizing such officer and for subordinating his claims to other creditors.

Barlow v. Budge, 127 F. 2d 440.

The appellant's position is somewhat stronger, in view of the fact that he was not an officer or director when the contracts of employment were entered into and that for sometime prior to the adjudication in bankruptcy he had ceased to be an officer and director of the bankrupt corporation.

It, therefore, must be admitted that the contracts of employment between the bankrupt corporation and the appellant were freely and fairly made and that no fraud was involved in their making.

B. The Appellant Was Not an Officer or Director of the Bankrupt Corporation for Sometime Prior to Its Adjudication and Was Not Responsible for nor Did He Contribute to Its Bankruptcy.

The foregoing statement is uncontradicted. The appellant became an officer and director of the bankrupt corporation on or about December 1, 1947 [Tr. pp. 75, 106]. He was not elected by any body of stockholders, but was appointed by Raymond Hacker, who at that time owned all of the outstanding stock [Tr. pp. 75, 105, 106]. Until the new interests came into the business, it was a one man corporation solely controlled, managed and dominated by Raymond Hacker [Tr. pp. 97, 106]. Appellant at no time owned any stock in the bankruptcy corporation nor did he have any financial interest therein [Tr. p. 75].

About the middle of 1948 when new parties became interested in the corporation, appellant was asked to and

id resign as an officer and director thereof [Tr. pp. 63, 5]. In September, 1948, he attempted to leave the em-loy of the bankrupt corporation because he had received n offer of another position, but was requested to stay on y the new parties who had agreed to contribute a large um of money to the corporation for working capital [Tr. . 71]. He is, therefore, further penalized by the Order f Subordination, because he could have obtained employ-nent elsewhere and earned a salary commensurate with his bility. Keeping the foregoing dates in mind, the bank-upt corporation made an Assignment for the Benefit of Creditors on March 21, 1949, and was adjudicated a bank-upt on May 12, 1949. The Findings of Fact and Con-lusions of Law, Paragraph IV, assume that appellant vas an officer and director during all the times hereinabove nentioned [Tr. pp. 30-32]. This is untrue and is not sup-orted by any evidence whatsoever. As a matter of fact, studied reading of said Paragraph IV clearly indicates hat it is not a Conclusion of Law at all but a series of suppositions created by the Referee, which have no basis n fact and are not supported by any evidence. It is based on two false premises: (1) that the appellant was an officer and director of the corporation from and after No-vember, 1947, to the date of bankruptcy and (2) that if he officers had been paid their guaranteed salaries at regular intervals the corporation would have become bank-upt sooner and thus would have had less creditors. There s no evidence in the record to substantiate these conclu-sions.

In any event, the mere fact that the business sometime after appellant's association therewith, proved to be un-successful and became bankrupt, even if he had been an officer and director at all times, should not of itself deprive

him of the right to share equally with other creditors upon a valid and enforceable claim filed by him against the debtor's estate.

Barlow v. Budge, supra.

C. The Salary Agreed to Be Paid to the Appellant Was Fair and Reasonable and Such Agreement Was Not Inequitable or Unjust to Other Creditors.

The Referee, whose orders were affirmed by the District Court, endeavors in Paragraph IV of the Conclusions [Tr. pp. 30-32] to straddle the issue, by holding that while the contracts were enforceable, they were not fair, equitable or just as against the creditors of the bankrupt corporation. As heretofore shown in Argument C, said conclusions were based on false premises. It has been shown that appellant's starting salary was equal to that which he had received in previous employment and same was increased when he was appointed General Manager. The Findings and Conclusions of Law do not state that these salaries are excessive or that the appellant's services were not reasonably worth the amounts agreed upon. As a matter of fact, the Referee himself supports our contention when he stated [Tr. p. 158]: "I'm not quarreling so much, as I said, with Mr. McDonell having an earning capacity of $20,000.00 . . ." The only points which are held as evidence to support the Referee's conclusions that the contracts are not fair, equitable or just as against the creditors, are the assumed facts regarding the period during which appellant was

n officer and director and the supposition that if he had ollected the guaranteed salary as he went along, the ankruptcy would have been precipitated earlier and per-aps some of the creditors would not have extended fur-ıer credit to the corporation. As heretofore argued, ıere is absolutely no evidence to substantiate this con-usion. Neither is there any evidence of moral turpitude r breach of duty on the part of the appellant.

A creditor must have been guilty of some moral turpi-ıde or some breach of duty whereby other creditors have een deceived to their damage, in order to estop him from haring in the distribution of the estate of the debtor with ll other creditors.

Crowder v. Allen West Co., 213 Fed. 177.

> "The claims of a corporate officer or director, aris-ing out of transactions with the corporation have been enforced when good faith and fairness were found."
>
> *Manufacturers Trust Company v. Becker*, U. S. Supreme Court Law Edition, Advance Opinions, Volume 94, No. 2, page 99 at page 103.

The Referee refused to permit the introduction of evi-ence showing the magnitude and amount of business ransacted by the bankrupt corporation, on the ground that ıe question for him to determine was whether or not ıere was an enforceable contract [Tr. pp. 106-107]. Iowever, he having found that there was an enforceable ontract, this phase of the matter becomes important to how that the appellant's salary was not excessive or un-

fair. However, during the hearing, some evidence was introduced by the witness Egan which clearly indicated that the bankrupt corporation performed some of the largest floor covering jobs in Los Angeles, enumerating some of them as the General Petroleum Building, Orbach's, Prudential Building, two or three dozen schools and the Burbank City Hall [Tr. pp. 83-84]. This testimony clearly supports appellant's contention that his salary was fair and reasonable and in no manner was it inequitable or unjust to the creditors. He gave his ability and experience to the corporation and its bankruptcy was not caused by any act of his but was clearly due to the lack of capital financing [Tr. pp. 62, 66, 85].

While the bankruptcy courts have the power to disallow or subordinate claims in bankruptcy, it should not so operate as to take away anything punitively to which one creditor is justly entitled in view of the liquidation finality and bestow it on others. Any subordination must be scrupulously measured and fitted to the actual injury that has been done or the unjust enrichment that is involved. (Bankruptcy Act No. 2, 57 sub. k, 1 U. S. C. A. No. 11, 93 sub. k.)

In re Kansas City Journal Post Co., 144 F. 2d 791 at 800.

D. The District Court's Orders Violate the Equality of Distribution of General Assets Guaranteed by the Bankruptcy Act.

The appellant is a general creditor whose claims have been allowed in full [Tr. pp. 33]. Since we are dealing with general creditors, the District Court's order is a direct violation of Section 65(a) of the Bankruptcy Act which provides (11 U. S. C. A. Sec. 105(a)):

> "Dividends of an equal percentum shall be declared and *paid* on all *allowed* claims, except such as have priority or are secured." (Italics added.)

The claims of the appellant are allowed claims but are not claims having priority under Section 64 of the Bankruptcy Act, nor are they secured claims. Admittedly, the fundamental principle of the act, is equality of distribution among the general creditors. Indeed, that is the very purpose of bankruptcy.

> "The Bankruptcy Act contemplates an equal division of the bankrupt's assets, with no preference except those designated in the statute."
>
> *In re Moore,* 11 F. 2d 62-63.

The effect of the order here, as the court said in *Merchants National Bank v. Sexton,* 228 U. S. 634, 643, "to disregard . . . and to destroy the equality of distribution which it was the purpose of that act to secure."

Therefore, the express provisions, as well as the policy of the Bankrupcy Act, require reversal of the District Court's Order.

E. Appellant's Employment With the Bankrupt Co poration Did Not Constitute a Joint Venture.

The conclusions reached by the Referee in Paragra IV, subdivision 4 of the Conclusions of Law [Tr. p. 32 *i. e.*, that the provisions of the employment contract wher by the appellant J. J. McDonell was to receive a percen age of the net profits constituted said appellant a joi venturer in the business of the bankrupt corporation, not sustained by the facts and is contrary to the laws this State. The following elements of a joint venture a lacking:

(a) The appellant had no interest in the corpora assets neither did his contract and employment gi him any and there was an entire lack of communi interest in said assets.

(b) There is no agreement that appellant sha in the losses as well as the profits.

(c) A joint venture is usually a contract betwe parties to carry out one transaction, whereas in t present instance, appellant was employed by a goin corporation which had carried on business long pri to his employment and continued to do so after h left.

Under *Section 15007 of the Corporation Code* of t State of California relating to partnership, subdivision reads as follows:

"The receipt by a person of a share of the profi of a business is *prima facie* evidence that he is a par ner in the business, but no such inference shall b drawn if such profits are received in payment: (b as wages by an employee or rent by a landlord."

There are many cases in this State which hold that t mere fact that a person receives a share of the profit

[illegible] a corporation is not entitled to relief from a partnership joint venture.

[illegible]

[illegible]

[illegible]

[illegible]

The last named case holds at page 245 of 40 Cal. App. that a partnership or joint enterprise is not formed where a corporation engaged in the general contracting business, enters into a contract with an individual who is an experienced builder of various buildings for a percentage of the "net profits."

Appellant, therefore, contends that he was only an employee of the business corporation with a fixed compensation, a portion of which was guaranteed, and that the agreement to give him a percentage of the net profits which might come to him as an employee of the corporation was not a joint venture. The facts which the subject matter of this action is based solely on the aforesaid letter. Furthermore, he was subject to discharge, which actually took [illegible]

Conclusion

It seems clear that the Trans Trust [illegible] is entitled to the [illegible] under circumstances similar [illegible] cases to those of all other general creditors as the law of the case allowed.

There can [illegible] in arriving at a conclusion on the part of the Trustee that the elements of employment existed [illegible] between the appellant and the business corporation were [illegible] with any fraud or collusion. Further

E. Appellant's Employment With the Bankrupt Corporation Did Not Constitute a Joint Venture.

The conclusions reached by the Referee in Paragraph IV, subdivision 4 of the Conclusions of Law [Tr. p. 32], *i. e.*, that the provisions of the employment contract whereby the appellant J. J. McDonell was to receive a percentage of the net profits constituted said appellant a joint venturer in the business of the bankrupt corporation, is not sustained by the facts and is contrary to the laws of this State. The following elements of a joint venture are lacking:

(a) The appellant had no interest in the corporate assets neither did his contract and employment give him any and there was an entire lack of community interest in said assets.

(b) There is no agreement that appellant share in the losses as well as the profits.

(c) A joint venture is usually a contract between parties to carry out one transaction, whereas in the present instance, appellant was employed by a going corporation which had carried on business long prior to his employment and continued to do so after he left.

Under *Section 15007 of the Corporation Code* of the State of California relating to partnership, subdivision 4 reads as follows:

> "The receipt by a person of a share of the profits of a business is *prima facie* evidence that he is a partner in the business, but no such inference shall be drawn if such profits are received in payment: (b) as wages by an employee or rent by a landlord."

There are many cases in this State which hold that the mere fact that a person receives a share of the profits

his compensation is not sufficient to make him a partner a joint venturer.

Freeman v. Sullivan, 86 Cal. App. 200;

Sievert v. Simmons, 89 Cal. App. 2d 34;

Krenz Copper and Brass Works Inc. v. England, 109 Cal. App. 747;

Fee v. McPhee Company, 31 Cal. App. 295.

The last named case holds at page 315 *et seq.,* that a rtnership or joint enterprise is not formed where a cor- ration engaged in the general contracting business, en- rs into a contract with an individual who is to superin- nd the construction of certain buildings for a percentage the "net profits."

Appellant, therefore, contends that he was only an em- oyee of the bankrupt corporation with a fixed compen- tion, a portion of which was guaranteed, and that the greement to give him a percentage of the net profits which never came to pass) as part of said compensation, oes not constitute him a joint venturer. The claim which the subject matter of this matter is based solely on his uaranteed salary. Furthermore, he was subject to dis- harge, which certainly makes him an employee.

Conclusion.

It seems clear that the District Court erred in confirm- ig the Referee's order subordinating appellant's general aims to those of all other general creditors in the face the facts adduced.

There has been no showing or even a contention on the rt of the Trustee that the contracts of employment en- red into between the appellant and the bankrupt corpora- on were tainted with any fraud or unfairness. Further,

it has been shown, without denial or contradiction, that the amount of the salary agreed to be paid to appellant, was fair and reasonable in view of his experience and former earnings in the floor covering industry, and as such could not be unfair or inequitable to other creditors. The District Court erred in assuming that the appellant was an officer and director of the bankrupt corporation from the beginning of his employment to the time of bankruptcy, and did not give sufficient consideration to the fact that while appellant was a director and officer of the corporation for a few months, and also was asked to and did resign about eight months prior to the adjudication, he at no time was a stockholder nor did he have any financial interest in the bankrupt corporation; he was merely an employee. Therefore, there has been no legal showing made to support the Order of Subordination which wrongfully deprives appellant of the salary he earned and was entitled to for the services rendered by him to the corporation.

The appellant, therefore, urges that the Order appealed from, be reversed; that the Order of Subordination be set aside and that appellant be permitted to share pro-rata with all other general creditors of the bankrupt corporation.

Respectfully submitted,

BENJAMIN & KRONICK,

By ROBERT I. KRONICK,

Attorneys for Appellant.